No. 95-1918

(12)

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

STATE OF ARKANSAS,

Petitioner,

v.

FARM CREDIT SERVICES OF CENTRAL ARKANSAS, PCA;
FARM CREDIT SERVICES OF WESTERN ARKANSAS, PCA;
EASTERN ARKANSAS PRODUCTION CREDIT ASSOCIATION;
and DELTA PRODUCTION CREDIT ASSOCIATION,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF OF THE AMICI CURIAE AMERICAN BANKERS ASSOCIATION AND NEBRASKA BANKERS ASSOCIATION IN SUPPORT OF PETITIONER

JOHN J. GILL III
Counsel of Record
MICHAEL F. CROTTY
MARK R. BARAN
AMERICAN BANKERS ASSOCIATION
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026

Counsel for Amici Curiae

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QUESTION PRESENTED

Whether privately owned, nontaxpayer-funded, profit-making production credit associations should be considered constitutionally immune from state sales and income tax as instrumentalities of the federal government.

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In The
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BRIEF OF THE AMICI CURIAE AMERICAN BANKERS ASSOCIATION AND NEBRASKA BANKERS ASSOCIATION IN SUPPORT OF PETITIONER

The American Bankers Association and Nebraska Bankers Association hereby respectfully submit this brief as

amici curiae in support of the Petitioner in accordance with the provisions of Rule 37.3 of the Supreme Court Rules. All parties have consented to this filing, and their written consents are filed with this brief.

INTEREST OF THE AMICI CURIAE

The American Bankers Association is the principal trade association of the banking industry in the United States, representing banks in each of the fifty states and the District of Columbia, including both national and state-chartered banks. The Association membership includes community, regional, and money center banks, bank holding companies, as well as savings associations, trust companies and savings banks, with combined assets totalling over ninety percent of all banking assets in the United States.

The Nebraska Bankers Association is a trade association with 324 of the 327 banks in Nebraska among its membership. A significant portion of the loan portfolios of Nebraska banks consist of agricultural loans. The tax immunity granted to production credit associations under the lower court ruling provide a significant competitive advantage to the detriment of Nebraska banks.

The decision of the Eighth Circuit conferring a blanket state sales and income tax immunity on production credit associations raises fundamental legal and public policy tax issues of substantial importance to the banking industry, agricultural banks in particular. Production credit associations are direct retail lenders, no longer owned by the United States government, and serve no governmental role

or function warranting a judicially created exemption from state and local taxation. Yet, the Eighth Circuit relied upon a production credit association's classification as a "federal instrumentality," absent any review of Congressional intent or factual analysis of a production credit association's governmental powers. Such a rigid interpretation of intergovernmental immunity is untenable and would have a profound impact on the banking industry.

Your amici believe that the views of the banking industry will assist the Court in deciding the merits of this case. By judicially creating immunity in this case, the unique competitive advantages that currently exist for Farm Credit System lending institutions would be unnecessarily strengthened at the expense of other similarly-situated privately owned commercial banks. Undeniably, production credit associations are private, commercial, profit-generating, retail institutions. As such, these associations should legally assume their fair share of responsibility for the cost of state governments, whose benefits they receive and whose protections they enjoy.

SUMMARY OF ARGUMENT

This case involves the proper interpretation of 12 U.S.C. Section 2077, and the extent to which privately owned, profitable, production credit associations should benefit from a constitutional immunity from state taxation. Section 2077 provides an exemption from all taxation on notes, debentures, and obligations issued by production credit associations. Prior to the Farm Credit Amendments Act of 1985, a production credit association's tax exemption

was contingent upon a continued proprietary interest by the United States government. The United States divested ownership in all production credit associations as of 1968. Since that time, production credit associations have been subject to applicable nondiscriminatory state and local taxes.

Consistent with principles of statutory construction, the Court should review the language, structure, and legislative history of the Farm Credit Act, and all relevant facts, and set appropriate limits on state taxation. Based upon these factors, it is clear that it was not the intent of Congress to provide a blanket exemption from state sales and income taxes for production credit associations throughout the United States. A Congressional Committee report described the removal of language relevant to this case as merely a technical amendment.[1] Further, the nondiscriminatory tax involved in this case applies to national banks, which have equal claim to federal instrumentality status. Obviously, the taxes are not, in that case, thought to obstruct or burden any federal function. There is no reason to think any differently in the case of production credit associations. Production credit associations possess many of the purposes and engage in essentially the same activities as private commercial banking or savings institutions. Absent a clear Congressional waiver from state sales and income taxation, no public policy interests exist to justify the creation of a judicial blanket exemption from state and local taxation. Finally, should the Court uphold the

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[1] House Rep. No. 92-593, 92nd Congress, 1st Sess. 2, *reprinted in* [1971] U.S. Code Cong. & Admin. News 2091, 2098.

decision of the Eighth Circuit, the competitiveness of the agricultural lending market would be threatened, and the desire of Congress to transform the Farm Credit System from a government-owned to a privately-owned and controlled system would be compromised.[2]

ARGUMENT

I. THE DECISION OF THE EIGHTH CIRCUIT MISCONSTRUES CONGRESSIONAL INTENT CONCERNING THE PROPER INTERPRETATION OF 12 U.S.C. SECTION 2077.

Production credit associations were created pursuant to the Farm Credit Act of 1933, to provide loans to farmers and ranchers. 12 U.S.C. Section 2071. Similar to other lending institutions in the Farm Credit System, production credit associations are statutorily classified as a "federal instrumentality." 12 U.S.C. Sections 1271(a), 1271(b)(7). Production credit associations are a vital component of a powerful nationwide network of lending institutions and financial entities within the Farm Credit System.[3]

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[2] House Rep. No. 287, 86th Congress 1st Sess. 1, *reprinted in* [1959] U.S. Code Cong. & Admin. News 2123.

[3] The Farm Credit System was initially created in 1916 pursuant to the Federal Farm Loan Act, Pub. L. No. 64-158, 39 Stat. 360 (1916). According to the Farm Credit Administration Quarterly Report for the quarter ending September 30, 1996, as of January 1, 1997, the Farm Credit System is currently comprised of 6 Farm Credit Banks, 1 Agricultural Credit Bank, 1 Bank for Cooperatives, and 217

In the Farm Credit Act of 1971, Congress made significant changes to the existing Farm Credit Act, including a number of revisions concerning the operation and structure of the Farm Credit System. At that time, Congress retained certain tax exemption provisions affecting production credit associations.[4] Within the Farm Credit Act of 1971, the tax provisions (relating to notes, debentures, or other obligations) for production credit associations read as follows:

> Each production credit association and its obligations are instrumentalities of the United States and as such any and all notes, debentures, and other obligations issued by such associations shall be exempt, both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now and hereafter imposed by the United

associations representing 65 Production Credit Associations, 60 Federal Land Bank Associations, 61 Agricultural Credit Associations, and 31 Federal Land Credit Associations.

[4] Farm Credit Act of 1971, Pub. L. 92-181, § 2.17, 85 Stat. 583, 602 (1971), (formerly designated 12 U.S.C. § 2098 and now codified in 12 U.S.C. § 2077). This section remained essentially the same as the Farm Credit Act of 1933 as it relates to the provision for exemption from Federal, State and local taxation for notes, debentures, or other obligations issued by production credit associations, (except surtaxes, estate, inheritance and gift taxes) and the United States stock ownership contingency associated with the waiver from Federal, state and local income taxation.

> States or any State, territorial, or local taxing authority. *Such associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now and hereafter imposed by the United States or any State, territorial, or local taxing authority; except that interest on the obligations of such associations shall be subject only to Federal income taxation in the hands of the holder thereof pursuant to the Public Debt Act of 1941 (31 U.S.C 742(a)) and except that any real and personal property of such associations shall be subject to federal, State, territorial, and local taxation to the same extent as similar property is taxed. The exemption provided in the preceding sentence shall apply only for any year or part thereof in which stock in the production credit associations is held by the Governor of the Farm Credit Administration.*

The last two italicized sentences of the preceding paragraph were deleted during technical and conforming amendments to the Farm Credit Amendments Act in 1985.[5]

[5] The Farm Credit Amendments Act of 1985, Pub. L. No. 99-205 (1985), made a number of technical changes to the powers and duties of the Farm Credit Administration. The most important and relevant change was the replacement of the Governor of the Farm Credit Administration with a three member board.

Nothing in the legislative history of this Act indicates an intent by Congress purposefully to remove the long-standing waiver of immunity. This is particularly true given the fact that by 1968, the United States did not own any stock interest in production credit associations. Accordingly, for almost thirty years, cooperatively owned production credit associations have not enjoyed statutory or constitutional immunity from state and local taxation.[6] Congressional activity relating to the deletion of the contingency language in 12 U.S.C. Section 2077 in 1985 should not, therefore, be translated into a Congressional intention to provide a broad tax immunity specific to production credit associations.

In an attempt to develop standards for determining Congressional intent in this conflicting area of constitutional immunity, the Court recognized that "[w]ise and flexible adjustment of intergovernmental tax immunity calls for political and economic considerations of the greatest difficulty and delicacy." *United States v. Detroit*, 355 U.S. 466, 474 (1958). Also, in *Helvering v. Gerhardt*, 304 U.S. 405, 411-12, n. 1 (1938), Chief Justice Stone noted that "[s]ince the acts of Congress within its constitutional power are supreme, the validity of state taxation of federal instrumentalities must depend (a) on the power of Congress to create the instrumentality and (b) its intent to protect it

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[6] It should be noted that previous attempts by production credit associations in claims of immunity from state taxation were unsuccessful. *Woodland Production Credit Association v. Franchise Tax Board*, 37 Cal. Rptr. 231 (1964); *Columbus Production Credit Association v. Bowers*, 180 N.E. 2d 1 (Ohio), *cert. denied*, 371 U.S. 826 (1962).

from State taxation. Congress may curtail an immunity which might otherwise be implied...or enlarge it beyond the point where, Congress being silent, the Court would set the limits." It hardly seems plausible that Congress, by its silence, intended to enlarge the scope of immunity for production credit associations in 12 U.S.C. Section 2077. The Court should, in this case, set appropriate state taxation limits and reexamine the Eighth Circuit's egregious misapplication of Congressional intent.

II. THE TAX INVOLVED IN THIS CASE FALLS NEITHER ON THE FEDERAL GOVERNMENT NOR ITS LAWFUL INSTRUMENTALITIES.

The Eighth Circuit held that no statutory provision exists, including 12 U.S.C. Section 2077, that indicates an intent on the part of Congress to waive tax immunity of production credit associations as federal instrumentalities. This reasoning is abstruse, as the decision implies that the Arkansas income and sales tax on profitable, privately owned retail institutions is an invalid encroachment of the constitutional tax immunity accorded the Federal Government. No practical reasons exist to provide a prohibition of nondiscriminatory state sales and income taxes on production credit associations serving no governmental function, other than to fulfill Congressionally mandated policy objectives.

Black's Law Dictionary defines a federal instrumentality as "A means or agency used by the federal government. A government agency immune from state

control."[7] Under this definition, modern production credit associations can hardly be considered as used by the federal government. Further, the associations' structure, activities, and operations do not warrant being classified as a government agency.

A history of the state taxation of national banks illustrates the application of the tax immunity to federal instrumentalities used by the federal government. While state-chartered banks have usually been subject to state taxation, national banks were considered constitutionally immune from some forms of state taxation due to the unique role and function they once served. The landmark case of *M'Culloch v. Maryland*, 17 U.S. (4 Wheat) 406 (1819), established an implied constitutional tax immunity in a case involving a discriminatory tax assessed against the Second Bank of the United States. Unlike today's national banks and production credit associations, however, the Second National Bank of the United States in *M'Culloch* was owned and controlled by the United States government. In addition, the Court was placed in an unenviable position of establishing judicial policy when the United States, "having only tiny revenues of less than $25 million, was quite weak in comparison with the relatively strong state governments."[8]

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[7] *Blacks Law Dictionary* (5th ed. 1983).

[8] Paul J. Hartman, *Federal Limitations on State and Local Taxation* 247 (1981).

Over the years, however, the notion of banks as federal instrumentalities of the federal government and created for a public purpose has eroded, even though the intergovernmental tax immunity doctrine, applied to a national bank as a federal instrumentality, was upheld in *First Agricultural National Bank of Berkshire County v. State Tax Commission*, 392 U.S. 339 (1968). In holding that states are without power to tax national banks, unless authorized by Congress, the Court in *First Agriculture National Bank*, stated:

> Because of pertinent legislation in the banking field, we find it unnecessary to reach the constitutional question of whether national banks should be considered nontaxable as federal instrumentalities.[9]

Unlike the Eighth Circuit's decision in this case, the Court in *First Agricultural* performed an analysis of Congressional intent, finding that Congress intended to prescribe only four types of permissible taxes as outlined in the federal statute.[10] In an eloquent dissent, Justice Marshall stated, "I think that in light of the present functions and role of

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[9] *Id.* at 341.

[10] At the time of the *First Agricultural* case, a 1926 amendment of § 5219 of the Revised Statutes was in effect, which permitted States to levy four specific types of taxes on national banks. The taxes were on (i) national bank shares, (ii) dividends in the hands of the shareholders, (iii) income of banks, and (iv) taxes according to or measured by the bank's income. A bank's real property was subject to tax.

national banks, they should not, in this day and age be considered constitutionally immune from nondiscriminatory state taxation...."[11] Recognizing that banks fail to possess any unique quality giving them the character of a federal instrumentality, Congress later responded and provided an explicit waiver of immunity from state and Federal taxation of national banks in 1973.[12]

In determining whether a private entity should be treated as immune from state taxation, courts must perform an analysis of the entity asserting federal instrumentality status. A similar analysis should be performed for production credit associations. In *Department of Employment v. United States*, 85 U.S. 355 1966, the Court conferred federal instrumentality status on the Red Cross, even though it is a private entity, reasoning that the statute and Executive Order "devolved upon the Red Cross...a wide variety of functions indispensable to the workings of our Armed Forces" and "assisting the Federal government in providing disaster assistance to the States in time of need." Sound legal analysis concerning the activities, structure, control, and ownership by the federal government were similarly performed in other cases before the Court.[13] If such an examination were performed by the Eighth Circuit

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[11] *Id.* at 349.

[12] *See* Section 5219, Revised Statutes, 12 U.S.C. § 548.

[13] *See Graves v. New York*, 306 U.S. 466 (1939); *United States v. Boyd*, 378 U.S. 39 (1964); *United States v. Township of Muskegon*, 355 U.S. 484 (1958).

in this case, a different result would most likely have been reached. Congressional silence should not present an opportunity to the courts to create an immunity from state sales and income tax to the detriment of similarly situated commercial lenders who offer similar loan products and services.

The tax status of cooperatively-owned federal credit unions is an important contrast to the varied applications of constitutional immunity extended to federal instrumentalities. Federal credit unions are granted a specific immunity from federal and state taxation in 12 U.S.C. Section 1768, without a corresponding Congressional designation as a federal instrumentality. Such a contrast is significant because national bank lenders, federal credit unions, and production credit associations are similarly situated financial institutions, albeit serving their own statutorily created public purposes.[14] Unlike production credit associations, however, the waiver from taxation for federal credit unions is clear and specific. Indeed, the Internal Revenue Service considers federal credit unions as instrumentalities of the federal government.[15] However, if the specific waiver

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[14] Under 12 U.S.C. § 1752(1), a federal credit union is defined as "a cooperative association organized in accordance with the provisions of this chapter for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes."

[15] Rev. Rul. 69-283; 1969 C.B. 156 (Federal credit unions are recognized as U.S. instrumentalities by the I.R.S. and are considered exempt under § 501(c)(1) of the Code. However, since they are not wholly owned by the U.S.,

language in 12 U.S.C. Section 1768 were inadvertently removed by Congress, it is uncertain, based upon the reasoning of the Eighth Circuit, whether federal credit unions would be entitled to a blanket exemption from state and local taxation as a federal instrumentality. Production credit associations, as statutorily declared federal instrumentalities, should not receive preferential treatment.

III. The Eighth Circuit Decision on The Tax Status of Production Credit Associations Would Adversely Impact The Commercial Agricultural Banking Industry.

The structure and operations of the Farm Credit System are strikingly similar to the current commercial bank system in the areas of examination, enforcement, capital and compliance requirements, and regulatory powers. The Farm Credit System consists of: (1) the Farm Credit Administration, which is a primary federal regulator that examines and supervises all System institutions, (2) the Farm Credit System Insurance Corporation, which insures the principal and interest on the system's debt securities, and (3) the Federal Farm Credit Banks Funding Corporation, which manages the sale of debt securities. The system also includes regional farm credit banks, 225 Farm Credit System lending institutions, and the Bank for Cooperatives.

Unlike government sponsored entities, such as the Federal National Mortgage Association, the Federal Home

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credit unions must file a Form 990 Annual Information Return).

Loan Mortgage Corporation, the Federal Home Loan Bank System, and the Student Loan Marketing Association, production credit associations are direct retail lenders and fierce competitors of commercial banks. The Farm Credit System's 1995 Quarterly Financial Report reported year-end total assets of $71.4 billion. Its institutions earned $1.2 billion in 1995, outperforming commercial farm banks on average return on assets and the percentage increase of total loans and assets. Yet, the most meaningful entries contained in the financial reports are the provisions for state, local, and federal income taxes. For 1995, lending institutions in the Farm Credit System paid approximately $137.4 million in taxes. Respondents' claim of immunity from taxation, therefore, has economic and competitive consequences that greatly outweigh any valid claim for constitutional immunity as a federal instrumentality.

On January 9, 1997, the Farm Credit Administration issued final regulations expanding the scope and eligibility of its lending operations.[16] During the official comment period, commercial banks expressed concerns relating to the appropriate role of government sponsored entities, such as the Farm Credit System. The Farm Credit Administration noted that "the presence of the System promotes competitive behavior among other lenders that serve these markets and contributes to the preservation of a well functioning capital market for agricultural and rural credit needs." Recognizing the Farm Credit System's limited relationship to the federal government, the Farm Credit Administration stated:

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[16] 12 C.F.R. Parts 613, 614, 615, 618, 619, 620, and 626; 62 Federal Register 4429 (January 30, 1997).

> The comment letters reveal a widespread misunderstanding about the System's purpose and relationship to the Federal government and to the public. Contrary to the belief of many commentators, the Farm Credit System is not a taxpayer-funded, government loan program. The Federal government: (1) Holds no capital stock in FCS institutions; (2) appoints no members to the boards of directors of any FCS bank or association; and (3) appropriates no funds to the System. Rather, FCS banks and associations are cooperatives that are owned and controlled by their member-borrowers.[17]

In an attempt to clarify certain misconceptions concerning the System's debt and the tax status of its institutions, the Farm Credit Administration also noted that those of its institutions (including production credit associations) holding 63 percent of total Farm Credit System assets are subject to federal taxation.[18] Unlike commercial banks, which rely on deposits for a primary source of funding, Farm Credit Banks issue Systemwide Debt Securities through the Federal Farm Credit Banks Funding Corporation. The system provides a low-cost source of

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[17] *Id.* at 4435.

[18] *Id.* at 4435. Data is as of September 30, 1996. The remaining 37 percent of assets are held by other forms of institutions within the Farm Credit System (not including PCAs) that are exempt from federal taxation.

borrowed funds for production credit associations and creates a substantial competitive advantage over commercial banks offering similar services. However, production credit associations, at least for purposes of risk and liabilities associated with the these securities, are not considered instrumentalities of the federal government.[19]

The most profound effect of the Eighth Circuit's decision is the probable economic hardship such a blanket tax immunity would have on competitors of the production credit associations, including banks represented by your amicus. If the decision in the Eighth Circuit were upheld, the costs of conducting a production credit association's retail lending business would be dramatically decreased. It logically follows that any legislative or judicial removal of any provision for taxes, without any corresponding public policy or compelling legal reason, would allow production credit associations to offer much lower rates on their short and intermediate-term loans and, in turn, provide their private owners with a significant return on their investments to the detriment of similarly situated taxpaying banks and their shareholders.

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[19] The Federal Farm Credit Banks Funding Corporation provides the following disclaimer to investors: "Systemwide Debt Securities are the joint and several liability of the banks and are not obligations, nor are they guaranteed by, the United States or any agency or instrumentality thereof, other than the banks." *Annual Information Statement-1994: Federal Farm Credit Banks Funding Corporation* at 14 (1995).

CONCLUSION

There are no compelling legal justifications for conferring state sales and income tax immunity on production credit associations. For the reasons cited above, the decision in the Eighth Circuit should be reversed.

Respectfully submitted,

John J. Gill III
Counsel of Record
Michael F. Crotty
Mark R. Baran

AMERICAN BANKERS ASSOCIATION
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026
Counsel for Amici Curiae

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